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This memorandum is in response to your request for informal technical assistance with regard to the appropriate treatment under section 956 of the Internal Revenue Code of the transactions described below.

Facts

and [REDACTED] are wholly-owned, domestic subsidiaries of [REDACTED]. [REDACTED] a division of [REDACTED] is located in [REDACTED] Texas. [REDACTED] is a wholly-owned Japanese subsidiary of [REDACTED], and a controlled foreign corporation within the meaning of section 957(a) of the Internal Revenue Code.

Since [REDACTED], [REDACTED] has been used to assist [REDACTED] in purchasing electronic merchandise in Japan and shipping it to the United States for resale. Under the terms of a Purchasing Agent Agreement dated [REDACTED], [REDACTED] agreed to act as purchasing agent for [REDACTED] in return for [REDACTED] to [REDACTED] percent of the purchase price of the merchandise purchased, plus reimbursement for all expenses incurred for the account of [REDACTED].

In its capacity as purchasing agent, [REDACTED] agreed to furnish [REDACTED] with price quotations and to place all purchase orders for [REDACTED]. [REDACTED] agreed to follow-up on deliveries of merchandise to warehouses in Japan, to inspect the merchandise, to prepare all shipping documents and to arrange for prompt shipment of the merchandise to the United States. The details of these

purchasing transactions follow

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████ issued purchase orders directly to unrelated Japanese vendors. The purchase orders were issued in █████'s name and state that "Within two (2) weeks after shipment, payable by _____ as agent for █████ in _____." It appears that the first blank is for the entity paying on behalf of █████, which in this case is █████, and that the second blank is reserved to indicate the type of currency that will be used.

Merchandise is delivered to █████'s warehouse in order to meet a ship that has been scheduled to depart. The vendor's invoice is submitted to █████'s data processing section for entry of the information thereon into inventory. The data processing section sums up the data of deliveries made during the month and reports the figures in their monthly statement (the "Summary of Purchase") which is submitted to the accounting section at the end of each month. █████'s accounting section makes entries for "purchase" and "payable to the vendors" based on the Summary of Purchase at the end of each month.

Meanwhile, the merchandise is loaded on the ship after customs clearance. The traffic section at █████ confirms the departure of the vessel. After that confirmation, a negotiation slip is submitted to the accounting section, which indicates that the shipment has been made. The traffic section also reports to the data processing section the completion of the shipment. The data processing section then writes off the merchandise from inventory based on this report.

The accounting section makes a billing to █████ once each week (usually on Thursday or Friday) based on the negotiation slips which the accounting section received from the traffic section that week. At the same time, the accounting section prepares an accounting voucher to post "sales" and "receivable to [████]." The accounting section makes the payment to the vendor within two weeks of shipment, as stated above, based on the payment voucher which is submitted by the data processing section. The accounting section also prepares the accounting voucher for the payment.

Prior to █████, █████ paid the invoices which it received from █████ within █████ days of the date on which the merchandise was shipped. Since █████ had two weeks from that same date in which to pay the vendors, it appears as though █████ could use █████'s funds, as opposed to its own funds, to pay the vendors.

However, beginning on █████, the purchasing practices outlined above changed. According to an internal memorandum which the Service has obtained from █████, █████ had a \$████ cash balance at █████. As part of a worldwide cash management plan that █████ implemented, it was decided to "draw down some of the cash from █████." Accordingly, the payment terms from █████ to █████ would be extended to utilize

the cash. The terms would be changed from net [] to net [] days. However, the unrelated vendors would continue to be paid by [] within [] days of shipment. This practice would "reduce and eliminate cash balances of []" in that [] would have its cash invested in merchandise paid for on behalf of []. The new credit terms extended by [] to [] of net [] days were less favorable than the terms that [] extended to unrelated entities ([] to [] days).

In addition to extending the credit terms, [] planned to provide parent company guarantees to foreign banks in order to establish a \$[] line of credit in favor of [] so that [] could borrow money in excess of the \$[] it had to finance further purchases on behalf of [].

At the end of []'s [] taxable year ([]), [] owed [] approximately \$[]. One year earlier, that amount was \$[], for a \$[] increase during the year.

Issue

The question presented is whether the change in credit terms from net [] to net [] days extended by [] to [] beginning on [], which increased the intercompany receivable in favor of [] by \$[] at the close of []'s [] taxable year constitutes an investment of []'s earnings in United States property within the meaning of section 956 and the regulations under that section.

Discussion

During 1985, section 951 (a) (1) (B) provided that a United States shareholder shall include in his gross income for his taxable year in which or with which the taxable year of controlled foreign corporation ends, his pro rata share of the controlled foreign corporation's increase in earnings invested in United States property for such year. The term "United States property" was defined in section 956 (b) (1) to include, inter alia, an obligation of a United States person.

However, certain obligations were excluded from the definition of "United States property." Section 956 (b) (2) (C) and § 1.956-2 (b) (1) (v) provided generally that any obligation of a United States person arising in connection with the sale or processing of property did not constitute "United States property" if the amount of such obligation outstanding at no time during the taxable year exceeded the amount which would be ordinary and necessary to carry on the trade or business of both the other party to the sale or processing transaction and the

United States person had the sale or processing transaction been made between unrelated persons.

Section 1.956-1 (d) (2) (ii) (a) defined the term "obligation" to exclude any indebtedness which is collected within one year from the time it is incurred. However, this exclusion did not apply to an indebtedness arising in connection with the sale or processing of property.

██████████ makes three principal arguments in support of its contention that the change in credit terms from net █████ to net █████ days did not result in █████ making an investment of its earnings in United States property. First, it argues that the exception provided by section 956 (b) (2) (C) for obligations arising in connection with the sale or processing of property that are ordinary and necessary in amount applies because the credit terms extended by █████ to █████ of net █████ days were less favorable than the terms that █████ extended to unrelated entities.

Second, █████ argues that section 482 principles are relevant in determining the ordinary and necessary nature of an obligation under section 956 (b) (2) (C). Specifically, █████ argues that §§ 1.482-2 (a) (3) and 1.482-2 (a) (1) together stand for the proposition that an intercompany advance which arises from the sale of products in the ordinary course of business need not provide for interest, if the advance is paid within 6 months of the date on which the debt arose, and that such an advance paid within such 6 month period will be deemed to be paid in the ordinary course of business. Since each obligation at issue was paid within █████ days, █████ argues that they fall within the safe harbor rule of § 1.482-2 (a) (3) and should, therefore, be excluded under section 965 (b) (2) (C).

Third, █████ relies on the "one-year rule" of former § 1.956-2 (d) (2) (ii) (a). Here, █████ takes the position that the obligations at issue did not arise in connection with the sale or processing of property, but arose from services that █████ performed for █████.

Moreover, in conjunction with its third argument, █████ argues that whether or not the obligations at issue could be characterized as arising in connection with the sale or processing of property, █████ contends that the Tax Court would apply both the section 956 (b) (2) (C) exception from the term "United States property" and the § 1.956-2 (d) (2) (ii) (a) exception from the term "obligation" in analyzing whether the obligations at issue constituted "United States property", citing Greenfield v. Commissioner, 60 T.C. 425, 430-434 (1973), aff'd 506 F.2d 972 (5th Cir. 1975).

In our case, subsequent to the date on which the taxpayer wrote to exam, the taxpayer abandoned its arguments set forth

above save that the one-year exception provided in § 1.956-2 (d) (2) (ii) (a) applies, according to the International Examiner.

Section 1.956-2 (d) (2) provides that the term "obligation" includes any bond, note, debenture, certificate, bill receivable, account receivable, note receivable, open account, or other indebtedness, whether or not bearing interest. Sec. 1.956-2 (d) (2). Clearly, once [REDACTED] fulfilled its obligations under the Purchasing Agent Agreement with respect to any one shipment of merchandise, an "obligation" arose between [REDACTED] and [REDACTED] within the meaning of the regulations. Accordingly, [REDACTED]'s [REDACTED] day credit terms to [REDACTED] could give rise to "United States property."

Our inquiry, however, does not end here. Section 1.956-2 (d) (2) (ii) (a), which was repealed effective June 14, 1988 with respect to investments made on or after June 14, 1988, excludes from the ambit of "obligation" any indebtedness (other than an indebtedness arising in connection with the sale or processing of property) which is collected within one year from the time it is incurred. According to the internal memorandums from [REDACTED], [REDACTED], the obligations which arose under the terms of the Purchasing Agent Agreement were to be paid within [REDACTED] days, which is well within one year. Therefore, the question becomes whether a continual series of [REDACTED] day obligations constitute a single "obligation" in the nature of a financing arrangement or a long-term loan for purposes of section 956. If so, then such an obligation, if outstanding at the end of [REDACTED]'s taxable year, constituted an investment in United States property within the meaning of section 956.

In this regard, we should focus on the applicability of Gulf Oil Corp. v. Commissioner, 87 T.C. 548 (1986) to the facts before us. In Gulf, the domestic parent corporation established a centralized cash management system "designed to minimize cash transfers among affiliated companies and to maximize the availability of cash[.]" 87 T.C. at 558. In Gulf, the Court characterized Gulf's centralized cash management system as:

. . . This is nothing more than a single open account loan.

The fact that the individual transactions that give rise to the upward and downward movements in account 1950 lose their individual identity under the cash management system is shown by petitioner's inability to trace individual transactions through the cash management system. [87 T.C. at 573.]

Ultimately, the Court held in favor of respondent stating that "Petitioner has failed in its burden of proof on this issue." 87 T.C. 573.

The case before us is similar to Gulf in that [REDACTED] appears to have a centralized, worldwide cash management system. [REDACTED] contends that each individual transaction was paid in [REDACTED] days, well within one year of the date on which it arose. In Gulf, the taxpayer made the same contention but was unable to prove it. Here, the International Examiner states that [REDACTED] can trace each receivable it has from [REDACTED], and can show the amount of the remittances it receives from [REDACTED]. Therefore, the Gulf decision may be of little value to us. The reason is that, in Gulf, the taxpayer lost ultimately on its failure to carry its burden of proof. The Service did not win, nor did the taxpayer lose, the section 956 issue on its merits.

The ultimate question becomes whether the Tax Court would have changed its holding in Gulf had the taxpayer been able to trace individual transactions through the cash management system and show that no single obligation was outstanding for more than one year. That question remains unanswered as the Court in Gulf did not need to reach it in order to form its holding.

In Sherwood Properties, Inc. v. Commissioner, 89 T.C. 651 (1987), the Tax Court was again faced with whether certain advances made by the taxpayer's controlled foreign corporation were repaid within one year. In Sherwood, the Tax Court stated:

There was a constant flow of merchandise and cash between [the domestic parent] and [the controlled foreign corporation]. [The domestic parent] paid over \$6,500,000 during the year ended June 30, 1978, to [the controlled foreign corporation]. However, we reject petitioners' argument that because [the domestic parent] repaid the advances 13 times during the year in terms of the total amount it paid [the controlled foreign corporation] the advances were repaid within 1 year. Cf. Gulf Oil Corp. v. Commissioner, 87 T.C. 548 (1986).

Petitioners argue that if the bookkeeper for [the domestic parent] had credited some of the payments from [the domestic parent] to the loan payable account there would be no [section 956] problem. We will not engage in such speculation. . . . [87 T.C. at 659.]

Once again, the Tax Court did not need to reach the precise question facing us, i.e., if the bookkeepers can trace each payment and show that no single transaction remained unpaid for more than one year, does section 956 apply. In Sherwood Properties the Court once again focused on the unique facts before it (that the bookkeeper made only one such entry to the loan payable account during the year), and found that the advances, if characterized as loans, were not repaid within one

year. The Court found further that the advances did not come within the exception of § 1.956-2 (d) (2) (ii) (a). Accordingly, the Court concluded that the advances were United States property and were included in the taxpayer's income.

It is our position, however, that a series of short term receivables, even if the payments on these obligations can be traced, can be viewed as one single obligation within the meaning of section 956. It is the substance of the series of transactions that determines their characterization for tax purposes.

Accordingly, in Rev. Rul. 89-73, 1989-1 C.B. 258, which is retroactive in its effect, the Service held that the purchase of debt obligations by the issuing domestic corporation's calendar year controlled foreign corporation, which matured and were repaid in November of year one, followed by the purchase of new debt obligations issued by the domestic corporation in February of year two constituted an investment of earnings in United States property under section 956. Obviously, one or both corporations in the revenue ruling could trace the inception and the payment of the obligations at issue. Nevertheless, the Service held that the obligations could be put together with the result that, at year end, there was in substance an obligation outstanding for more than one year.

However, in an unnumbered GCM dated June 28, 1983, issued prior to the enactment of sections 864 (d) and 956 (b) (3), we held that section 956 (b) (2) (C) applied to obligations that arose when the domestic parent sold inventory to unrelated domestic purchasers in exchange for accounts receivable and then factored these accounts receivable to its controlled foreign corporation. Here, we have a situation which is arguably the reverse of that set forth in the GCM. Thus, it can be argued, and it is our position, that the section 956 (b) (2) (C) exception applies to controlled foreign corporations indirectly involved in the sale or processing of property, at least where the controlled foreign corporation can show that such involvement is an ordinary and necessary part of its trade or business. Cf. Greenfield, 60 T.C. at 432-433, where the Tax Court recognized that there were business reasons for the controlled foreign corporation to advance funds to the domestic parent on account of the domestic parent's acquisition of goods and services for the controlled foreign corporation, but failed to perceive why such reasons made that practice ordinary and necessary to the controlled foreign corporation's business (as an electrical contractor) to provide such funds in such amounts that there was always a substantial balance due to the controlled foreign corporation at its year end. The court concluded that the controlled foreign corporation was actually financing the domestic parent's operations and that such financing was incompatible with the controlled foreign corporation's business

as a contractor.

In this case, the domestic parent purchased inventory from unrelated vendors, employing the funds of its controlled foreign corporation, and then paid off the obligations to its controlled foreign corporation, albeit over a period of time that was extended from [REDACTED] to [REDACTED] days. Although taxpayer has apparently abandoned its section 956 (b) (2) (C) argument, we believe we are vulnerable to a favorable taxpayer argument under section 956 (b) (2) (C). Unlike the controlled foreign corporation in Greenfield, [REDACTED] is a purchasing agent, not only for [REDACTED], but for at least one unrelated entity. Moreover, the [REDACTED]-day terms on which [REDACTED] extends credit to [REDACTED] are ordinary and necessary terms, particularly when compared to the [REDACTED] to [REDACTED] day terms that [REDACTED] extended to other entities.

Conclusion

In the case before us, there is an obligation outstanding at year end. The position of the Office of Associate Chief Counsel (International) is that Rev. Rul. 89-73, supra, can be employed to find that the obligation was outstanding for a period in excess of one year and therefore constitutes an investment of earnings in United States property within the meaning of section 956, even if [REDACTED] can trace the repayment of each [REDACTED] day receivable. However, we recommend that the issue not be pursued in this case, because we think there are strong arguments for excepting the obligations from the definition of "United States property" under section 956 (b) (2) (C).

If you need further assistance on this matter, please contact Mr. Lundeen at FTS 566-6645.

PHYLLIS E. MARCUS

cc: Val Albright